# STATE OF WASHINGTON
# OFFICE OF THE INSURANCE COMMISSIONER

FINANCIAL EXAMINATION

of

**Farmers Insurance Company of Washington**
**Mercer Island, Washington**

NAIC CODE 21644
DECEMBER 31, 2003

Participating States:
Washington

Order No. G05-40
Exhibit A

## CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of Farmers Insurance Company of Washington of Mercer Island, Washington. This report shows the financial condition and related corporate matters as of December 31, 2003.

Patrick H. McNaughton

PATRICK H. McNAUGHTON
Chief Examiner

June 23, 2005

Date

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SALUTATION

Seattle, Washington
June 23, 2005

The Honorable Alfred E. Gross, Commissioner
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
Chair, NAIC Financial Condition (E) Committee
PO Box 1157
Richmond, VA 23219

The Honorable Linda Hall
Director, Alaska Division of Insurance
NAIC Secretary, Western Zone
550 West 7th Avenue, Suite 1560
Anchorage, AK 99501-3567

The Honorable Mike Kreidler, Commissioner
Washington State Office of the Insurance Commissioner (OIC)
Insurance 5000 Building
5000 Capital Blvd.
Tumwater, WA 98501

Dear Commissioners and Director:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

**Farmers Insurance Company of Washington**

of

Mercer Island, Washington

hereinafter referred to as "FICOWA" or the "Company," at the location of its home office, 3003 77th Avenue SE, Mercer Island, WA 98040-2890. This report is respectfully submitted showing the condition of the Company as of December 31, 2003.

## SCOPE OF EXAMINATION

This examination covers the period January 1, 1999 through December 31, 2003 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC) and Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination.

This examination was conducted with reliance upon the California Department of Insurance (CDI) examination of transactions of affiliated Property and Casualty (P&C) companies of Farmers Group, Inc. (FGI). The Washington examiners placed reliance on the work performed by the California CDI as it related to common corporate records, aspects of the Company's operating procedures, financial records, and pooled reserves. The Washington examiners reviewed that work and performed other tests to ensure compliance with Washington insurance statutes. The findings are commented on in the following section of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

## INSTRUCTIONS

The examiners reviewed the Company's filed 2003 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review:

1. **Losses and Loss Adjustment Expenses (LAE)**

   American Actuarial Consulting Group, LLC (AACG) was retained by the CDI to conduct a review and provide an opinion on the loss and LAE reserves carried by Farmers Insurance Exchange (FIE), the lead company in the intercompany reinsurance pool, as of December 31, 2003. A casualty actuary from the CDI reviewed the work of the AACG consulting actuary.

   Because the business of Farmers P&C companies is pooled, it was necessary to review the losses and loss adjustment expense reserves on a group-wide basis. Based on the aforementioned actuarial review which was subsequent to the of the 2003

Annual Statement filing, the total indicated combined net loss and loss adjustment expense reserve deficiency (including pooled and non-pooled reserves) was $1,128,889,000 as of December 31, 2003. After pooling, FICOWA's portion was $17,835,000.

RCW 48.12.090(1) states: "The reserves for outstanding losses and loss expenses under policies of personal injury liability insurance and under policies of employer's liability insurance shall...make a reasonable provision for all unpaid loss and loss expense obligations of the insurer under the terms of such policies." As it was subsequently determined that the reserves were deficient, an adjustment for $17,835,000 is included in the financial statements of this examination report. (See examination adjustment A1 and A3)

In its 2004 NAIC Annual Statement, FICOWA strengthened its reserves for accident years 2003 and prior by $10,612,000.

**The Company is instructed to comply with RCW 48.12.090(1) by making a reasonable provision for all unpaid loss and loss expense obligations in the future.**

**2. Contingent Litigation**

The Company was a party to two material lawsuits regarding claims adjusters' overtime: (1) Bell vs. FIE (the "Bell" Case), which is a class-action suit specific to California-region employees, and (2) a second case similar to the Bell case, which was filed in Oregon. Subsequent to filing, the second case consolidated other similar cases of non-California regions into a Federal Court in Oregon. The Bell case jury verdict of July 2001 was on appeal when the 2003 annual statement was filed. Subsequent NAIC Annual Statement disclosures, the apparent facts of the cases, and subsequent settlement activity indicate that these two class-action lawsuits were accruable liabilities at December 31, 2003. In fact, the reinsurance pool included a $30.3 million accrual for this litigation, with 2% being ceded to the Company based on its participation in the reinsurance pool.

Subsequent to the filing of the 2003 annual statement it was determined that the actual liability was significantly higher. The 2004 NAIC Annual Statements of the Farmers P&C companies accrued total expenditures for the combined expected resolution of these two cases in a group-wide amount of $224.8 million. This accrual was for activity prior to 2004 and anticipated overtime compensation and interest for calendar year 2004. The total amount for these two cases that would be relevant to a December 31, 2003 accrual was $227,100,654. Company personnel provided the examiners with a further breakdown of this amount, less the $30.3 million liability already carried group-wide for the "Bell" case. The additional group-wide accrual indicated was $196,800,654. FICOWA's portion of this additional liability was $3,936,000. An adjustment in the amount of $3,936,000 is included in the financial statements of this examination report. This adjustment is classified as "aggregate write-ins for liabilities" in the NAIC Annual Statement and in this examination report. (See examination adjustment A2 and A3)

SSAP No. 5, paragraph 7, states: "An estimated loss from a loss contingency…shall be recorded by a charge to operations if both of the following are met: (a) Information available prior to the issuance of the financial statements indicates that it is probable that…a liability has been incurred at the date of the statutory financial statements… and (b) The amount of loss can be reasonably estimated." RCW 48.05.073 requires the Company to file its financial statements in accordance with the AP&P. The Company's accrual for these cases as of December 31, 2003 was materially deficient.

**The Company is instructed to comply with RCW 48.05.073 by filing its financial statements in accordance with the AP&P.**

### 3. Management Service Agreement with Affiliate

The Company does not have any employees. FGI provides operating and management services to FIE in its capacity as the attorney-in-fact of FIE, in accordance with the subscription agreements between FIE and its Members. All claims adjusting services are performed by employees of FIE. Expenses for claims adjusting and operating and management services are then allocated from FIE to FICOWA. The examiners requested but did not receive copies of any existing written management services agreements between FICOWA and FGI or FIE.

RCW 48.31B.025(2)(v) requires insurers subject to registration to include information regarding all management agreements, service contracts, and cost-sharing agreements in their registration statement. Our review indicated the Company has failed to disclose intercompany cost allocation and administrative service agreements between FICOWA and its affiliates pursuant to RCW 48.31B.025(2) and WAC 284-18-920, Form B, Item 5: "TRANSACTIONS AND AGREEMENTS".

RCW 48.31B.030(1)(a) requires inter-company transactions to meet the following standards:
(i) The terms must be fair and reasonable;
(ii) Charges or fees for services performed must be fair and reasonable;
(iii) Expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied;
(iv) The books, accounts, and records of each party to all such transactions must be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties; and
(v) The insurer's surplus regarding policyholders after dividends or distributions to shareholders or affiliates must be reasonable in relation to the insurer's outstanding liabilities and adequate to its financial needs.

**The Company is instructed pursuant to RCW 48.31B.025(2)(c)(v) to file an amended annual registration statement which adequately discloses the terms and conditions of the cost allocation and administrative agreements.**

Prior to the issuance of this report, the Company submitted to the Washington Office of the Insurance Commissioner (OIC) a management services agreement between the Company and FIE, the provider of record for management services. This agreement broadly encompasses management services, claims adjustment services, and investment advisory services. Approval from the OIC is pending

**4. Custodial Agreements**

Although the Company responded in its 2003 NAIC Annual Statement General Interrogatories, Question 23, that its custodial agreement with JPMorgan Chase Bank (JPMorgan) complied with the FCEH, both the Agreement and Rider did not contain several provisions required by the FCEH. In addition, the Company's undisclosed custodial agreement with Bank of New York (BNY) did not contain all provisions required by the FCEH. For example, both the JPMorgan agreement and Rider as well as the BNY agreement allowed for the use of a non-qualified custodian, which does not comply with RCW 48.13.450.

**The Company is instructed to correct all of the deficiencies and execute a revised or amended Agreement and Rider with JPMorgan Chase Bank and a revised or amended agreement with BNY pursuant to RCW 48.13.450.**

**The Company is instructed to comply with RCW 48.05.250 by filing a true statement of its financial condition, transactions, and affairs.**

**The Company is instructed to comply with WAC 284-07-050(2), requiring the Company to file its NAIC Annual Statements in accordance with the NAIC Annual Statement Instructions. Adherence to the FCEH is one of the requirements of the NAIC Annual Statement Instructions.**

**5. Commingling Cash**

In addition to the cash reported on page 2, line 5 of the 2003 NAIC Annual Statement, the Company's general ledger reported premium deposit balances totaling approximately $2,413,200,000, and claim check liabilities totaling $3,313,729,599; with equivalent offsetting balances. The premium and loss amounts are not meaningful because the Company commingles these balances with its affiliates. The Company referred to them as cumulative "balancing" amounts for which special programming would be required to provide any detail.

RCW 48.05.280 requires insurers to keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company's current practice of commingling cash and offsetting it in total does not meet the requirements of the Code. In addition, by commingling its premium receipts and claim payments with its affiliates and offsetting the balances in full, the Company's balance sheet does not reflect the cash that belongs to the Company.

**The Company is instructed to isolate its cash, identify its outstanding claims checks and collected premiums, and properly reflect the cash associated with these amounts in its ledger in compliance with RCW 48.05.280.**

**6. NAIC Annual Statement Errors and Misclassifications**

The examination team discovered several instances in which the Company's 2003 NAIC Annual Statement did not conform to the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions.

**The Company is instructed to comply with RCW 48.05.073, RCW48.05.250, and WAC 284-07-050(2) in filing its NAIC Annual Statement in accordance with the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions. The following exceptions were noted in our examination:**

**Notes to Financial Statements**

The 2003 NAIC Annual Statement instructions require that the details pertaining to the reporting entity shall be disclosed in the Notes to Financial Statements. In Note No. 12, "Retirement Plans, Deferred Compensation, Postemployment Benefits and Compensated Absences and Other Postretirement Benefit Plans," the Company disclosed the aggregate "net amount recognized at end of year" for all participating Farmers companies of $39.3 million for 2003. However, it failed to disclose the net amount recognized at end of year attributable to FICOWA. The Company's 2003 Notes to Financial Statements No. 12 does not meet the detail disclosure requirements of the 2003 NAIC Annual Statement Instructions. Therefore, the Company is not in compliance with WAC 284-07-050(2) and RCW 48.05.250.

Note 21 of the 2003 Notes to Financial Statement, page 14.9 states: "Restatement of Beginning Balances. Certain changes were made in 2002, which impacted the assignment of direct loss and loss adjustment expense reserves by company, state, and line of business. A new method was employed to assign Incurred But Not Reported (IBNR) loss and loss reserves by state for Farmers' Property & Casualty (P&C) Companies; auto, fire, and commercial lines of business. The beginning balances for direct unpaid losses and loss adjustment expenses were restated on the "Exhibit of Premiums and Losses (Statutory Page 14)" to be consistent with the change. For further information regarding the restatement, please contact (the) Director of P&C Accounting..."

SSAP 3 defines this change as a "change in accounting principle" because it results from a method of applying an accounting principle which differs from the principles or methods previously used for reporting purposes. SSAP 3 requires the following disclosures for changes in accounting principle:

- A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

- The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

- The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material.

The Company did not include the disclosures required by SSAP 3. RCW 48.05.073 and WAC 284-07-050(2) require the Company to file its financial statements in accordance with the AP&P.

The 2003 NAIC Annual Statement Instructions require that the description of management contracts and cost-sharing arrangements shall be disclosed under item F of Notes to Financial Statements No. 10 "Information Concerning Parent, Subsidiaries and Affiliates." The Company's 2003 disclosure was limited to the statement of its Generally Accepted Accounting Principles (GAAP) compliance with existing contracts. However, it failed to include a description of the Company's current cost allocation arrangement from the inter-company pooling arrangement. To be specific, the NAIC Annual Statement Instructions require that the note disclosures include a description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. WAC 284-07-050(2) requires the Company to file its NAIC Annual Statements in accordance with the NAIC Annual Statement Instructions.

The Company disclosed in its 2003 Notes to Financial Statement, Note #23(a), that the unsecured reinsurance recoverables were in thousands, while in fact those numbers should have been in millions. RCW 48.050.250 requires the Company to file a true statement of its financial condition, transactions, and affairs.

## COMMENTS AND RECOMMENDATIONS

**None**

## COMPANY PROFILE

### History and Capitalization

The Company was incorporated under the laws of the state of Washington on July 14, 1970 as a stock insurer. It received its Certificate of Authority on July 28, 1970 to transact disability, inland marine, general casualty, and surety insurance and commenced business on October 31, 1970. The Company is a member of the Farmers P&C Companies, headquartered in Los Angeles, California. The Company became a member of a Holding Company System on April 20, 1992 through filing of an Insurance Holding Company System Registration Statement with the OIC. The Company has no subsidiaries.

Authorized capital of the Company is $650,000, consisting of 6,500 shares of common stock with a par value of $100. All authorized shares were issued and outstanding at December 31, 2003. The stock is owned by affiliated California domiciled companies, as follows:

| | % | Shares |
|---|---|---|
| Fire Insurance Exchange (FIIE) | 80 | 5,200 |
| Truck Insurance Exchange (TIE) | 20 | 1,300 |
| Total | 100 | 6,500 |

### Territory and Plan of Operation

The Company's authorized lines of business are: Property, Marine & Transportation, General Casualty, and Vehicle & Surety.

Approximately 85 percent of the business written by the Company was homeowners, auto liability, and auto physical damage insurance. Sales operations of the Company are conducted through approximately 720 field agents who are appointed as independent contractors to represent the Company, as well as other Farmers P&C companies. District managers are independent contractors appointed for the purpose of recruiting and training new agents and providing liaison and advisory services between the companies and the agents.

Claims are serviced through 7 branch claims offices located in the state of Washington, as follows:

| | |
|---|---|
| Kirkland | Spokane |
| Tacoma | Vancouver |
| Bellevue | Yakima |
| Renton | |

In addition, some administrative claims staff are located in the Tigard, Oregon Northwest Service Center office, providing administrative support to the 7 branch claims offices.

**Growth of Company**

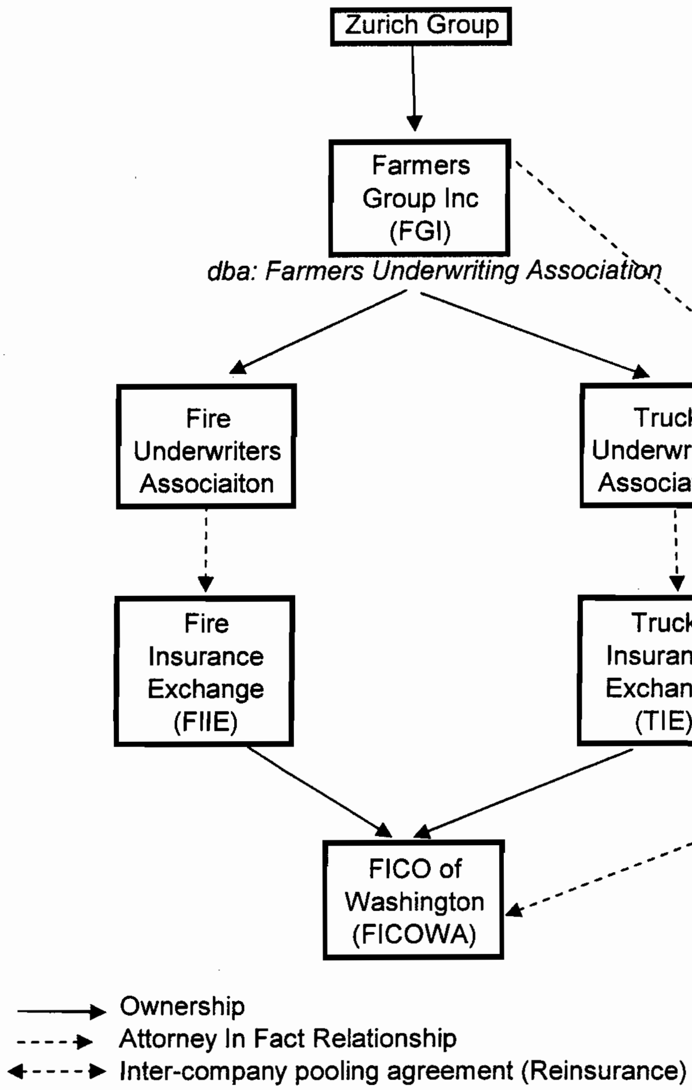
The Company's growth, as reported in its filed NAIC Annual Statements, is illustrated below:

| Year | Admitted Assets | Liabilities | Capital & Surplus |
|---|---|---|---|
| 2003 | $324,312,698 | $217,225,652 | $107,087,046 |
| 2002 | 322,718,521 | 224,441,909 | 98,276,614 |
| 2001 | 341,546,074 | 248,111,490 | 93,434,583 |
| 2000 | 292,941,171 | 189,577,449 | 103,363,722 |
| 1999 | 301,080,327 | 184,022,940 | 117,057,387 |

| Year | Net Written Premium | Net Underwriting Gain (Loss) | Net Investment Gains (Losses) | Net Income |
|---|---|---|---|---|
| 2003 | $169,475,533 | ($1,021,692) | $13,009,006 | $7,233,677 |
| 2002 | 193,467,387 | (8,691,775) | 20,522,625 | 5,427,972 |
| 2001 | 203,754,422 | (35,638,860) | 9,095,509 | (18,649,895) |
| 2000 | 201,959,818 | (29,802,650) | 11,912,325 | (12,312,214) |
| 1999 | 207,080,715 | (17,387,091) | 13,218,586 | (3,970,968) |

## AFFILIATED COMPANIES

The following is an abbreviated organization chart.




## MANAGEMENT AND CONTROL

### Ownership

Management of the Company is vested in a Board of Directors (Board) made up of not less than five and not more than nine members as provided for by the Company's Bylaws. The Board and the stockholders meet in March of every year. Directors may, but need not be, stockholders. A majority of the directors constitutes a quorum for the transaction of business. The Board also has an investment committee consisting of three officers who authorize the purchases and sales of investment securities. In addition, the Board has appointed an executive committee, which may consist of two or more directors.

**Board of Directors**

The following individuals were serving on the Board as of December 31, 2003:

| Name | Legal Residence | Principal Occupation |
|---|---|---|
| Richard M. Shriver | Newcastle, WA | President, FICOWA |
| Martin D. Feinstein | Thousand Oaks, CA | President and CEO – Farmers Group, Inc. |
| C. Paul Patsis | Seattle, WA | President and CEO– Farmers New World Life Ins. Co. |
| Paul N. Hopkins | Thousand Oaks, CA | Executive Vice President – Market Management |
| James I. Randolph | Issaquah, WA | Corporate Secretary |
| Robert P. Simmons, Jr. | Tigard, OR | Executive Director |
| Stephen E. Ferdinand | Tigard, OR | Commercial Center Manager |

**Officers**

Corporate officers are elected annually by the Board. The following persons were serving as officers as of December 31, 2003:

| | |
|---|---|
| Richard M. Shriver | President |
| Martin D. Feinstein | Vice President |
| Stephen E. Ferdinand | Vice President |
| Leonard H. Gelfand | Vice President |
| Laszlo G. Heredy | Vice President |
| Paul N. Hopkins | Vice President |
| Kevin E. Kelso | Vice President |
| Bryan F. Murphy | Vice President |
| Ronald G. Myhan | Vice President |
| C. Paul Patsis | Vice President |
| Keitha T. Schofield | Vice President |
| Robert P. Simmons, Jr. | Vice President |
| Stanley R. Smith | Vice President |
| Warren B. Tucker | Vice President |
| Pierre C. Wauthier | Vice President & Assistant Treasurer |
| Wayne D. Wilson | Vice President |
| James I. Randolph | Secretary |
| John P. McCoy | Treasurer |
| James C. Daues | Assistant Secretary |
| Robert Evoy, Jr. | Assistant Secretary |

| | |
|---|---|
| Paula M. Garavaglia | Assistant Secretary |
| Doren E. Hohl | Assistant Secretary |
| Kathleen D. Katovich | Assistant Secretary |
| Daniel R. McGarry | Assistant Secretary |
| Douglas S. Menges | Assistant Secretary |
| John R. Patton | Assistant Secretary |
| Richard L. Russell, Jr. | Assistant Secretary |
| Roland E. Senechal | Assistant Secretary |
| Kathryn M. Trepenski | Assistant Secretary |
| Jane A. Tutoki | Assistant Secretary |
| Hubert L. Mountz | Assistant Secretary |
| James L. Nutting | Corporate Actuary – Reserves & Financial Analysis |

**Conflict of Interest**

The Company has a policy whereby members of the Board, officers, and certain managerial employees are required to sign a conflict of interest statement each year. The purpose of the statement is to detect any activities or participation on the part of an employee that could possibly be interpreted as having the appearance of a conflict of interest. No such conflicts were noted during the last five years.

**Fidelity Bond and Other Insurance**

The Company is a named insured, along with other members of the Farmers P&C Companies, on fidelity bonds and other types of corporate insurance policies. The aggregate limit of coverage under the fidelity bond was $15 million as of December 31, 2003, which exceeded the NAIC recommended minimum coverage.

**Officer's, Employees', and Agents' Welfare and Pension Plans**

The Company has no employees. All administrative functions of the Company are performed by employees of FGI. Claims processing is handled by employees of FIE. Employees of FGI and FIE are covered under the Company's noncontributory pension plan. Substantially all employees who have reached the age of 21 and rendered one year of service are covered under the plan.

The Company has two profit sharing plans. The Deferred Profit Sharing Plan is limited to a maximum of 15 percent of the annual salary or wages paid or accrued to the eligible employee and provides for an annual payment by the Company to a trust for eventual payment to employees as provided in the plan. The Cash Profit Sharing Plan provides for annual cash distributions limited to a maximum of 5 percent of the annual salary or wages paid or accrued to the eligible employee.

The Company's agents are independent contractors. However, group life and medical plans are available to them on a contributory basis.

## CORPORATE RECORDS

The examiners reviewed the corporate records of FICOWA for the period under examination. The minutes of meetings of stockholders, directors, and committees were adequately approved and supported company transactions and events.

All Board meetings were conducted with a quorum present. The Articles of Incorporation were amended in 2000 to change the Company's address, and the Board members ratified the changes. The Bylaws were not amended during the period under review.

## LOSS EXPERIENCE

The reserve carried by the Company for Unpaid Losses was $93,162,566 and the reserve for Loss Adjustment Expenses was $28,492,007 as of December 31, 2003.

Because the business of the Farmers P&C companies is pooled, it was necessary to review the loss and loss adjustment expense reserves on a group-wide basis (the non-pooled business was not reviewed). AACG was retained by the CDI to conduct a review and provide an opinion on the loss and loss adjustment expense reserves carried by FIE, and other pooled companies, as of December 31, 2003. A casualty actuary from the CDI reviewed the work of the AACG consulting actuary.

Based on the aforementioned actuarial review, FIE had an indicated combined net loss and loss adjustment expense reserve deficiency of $469,374,000 as of December 31, 2003. FICOWA's loss and loss adjustment expense reserve deficiency amounted to $17,835,000, which has been adjusted for the purposes of this examination report. (See examination adjustment A1 and A3)

FIE subsequently strengthened its carried reserves for accident years 2003 and prior by $315.8 million in its 2004 NAIC Annual Statement. FICOWA subsequently strengthened carried reserves for accident years 2003 and prior by $10.6 million in its 2004 NAIC Annual Statement.

## REINSURANCE

The Company is affiliated with a number of the Farmers P&C companies, which are subsidiaries of the ultimate parent, the Zurich Group. As such, the Company is party to a 1970 "Reinsurance Assumption Agreement", whereby FIE, an affiliated entity, assumes all FICOWA's "net retained liability". FICOWA is also a party to a "1999 Inter-Company Reinsurance Agreement" which is a pooling agreement under which the Company, FIE, and various other affiliates of the Farmers P&C companies cede all of their business in force to FIE, which in turn retrocedes a stipulated portion of the pooled business back to the each participating company. Under this pooling agreement, FICOWA receives a 2% share of the pooled business.

Under the above agreements, the Company shares its liabilities with all other members of the pool. Therefore, it is substantially protected from its own unique exposures, but is also exposed to a portion of those from the other pooled companies.

In order to mitigate the overall pooled exposures, FIE maintains various excess of loss and catastrophe covers that protect against the following: California earthquake property exposure to $1 billion in excess of $300 million; Texas catastrophe property exposure to $1.5 billion in excess of $350 million; multi-event, non-hurricane property exposure outside of California and Texas to $200 million in excess of $20 million; single event per risk property coverage to $50 million excess of $2.5 million; workers compensation to $35 million excess of $5 million; third party liability to $50 million in excess of $10 million; and healthcare professional liability to $20 million excess of $2 million.

In addition to the above, FIE, FICOWA and other Farmers P&C companies participate in quota share treaties whereby a portion of their auto physical damage (APD), 10% of all lines, and 20% of their personal lines auto business are ceded to affiliates, Zurich Insurance Company and Farmers Re and other reinsurers. These contracts, which limit the reinsurers' share of the ceded liability to 95% of gross reinsurance premiums for APD and to about 113% for the other two contracts, were accepted by FIE's CPA's and domiciliary state regulators as complying with the risk transfer requirements of SSAP No. 62. For 2003, reinsurance commission rates were 18% for APD, 36.1% for all lines, and 37.2% for auto personal lines. In 2003, the total amount of ceded premiums, ceded losses or loss recoveries, and commission income was $81.6 million, $49.5 million and $30.8 million, respectively.

As of December 31, 2003, the Company had unsecured, undisputed reinsurance recoverables of $425.4 million for paid and unpaid losses, IBNR, LAE, and unearned premiums. These recoverables amounted to about 397% of the $107.1 million of the Company's total capital and surplus.

## ACCOUNTING RECORDS AND INFORMATION SYSTEMS

The Company maintains its accounting records on an accrual Statutory Accounting Basis, in accordance with Statutory Accounting Principles (SAP). The Company is audited annually by the CPA firm of PricewaterhouseCoopers (PWC). The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no exceptions were noted.

The examination of FICOWA's Information Systems (IS) and controls was performed in conjunction with the CDI's examination of FIE and the participating pooling companies as of December 31, 2003. The CDI contracted with Ernst & Young (E&Y) to review certain general IS controls of FIE. The engagement was performed in accordance with a proposal letter dated September 30, 1997, and the review of the IS and controls was performed as of December 31, 2002.

The E&Y review covered the following general IS controls surrounding the systems and applications that support the following significant business cycles:

- Investment
- Premium
- Reinsurance
- Loss and Benefit
- Financial Reporting
- Borrowed/Surplus
- Administration

For purposes of the examination of FICOWA, the examiners relied upon the review and summary reports of the E&Y audit as of December 31, 2002. The review of the internal controls for the significant business cycles was sufficient to provide assurance that appropriate controls have been implemented in accordance with NAIC Guidelines.

## SUBSEQUENT EVENTS

### Loss and LAE Reserves

As discussed in the Instructions section of this report, subsequent to filing its December 31, 2003 NAIC Annual Statement, the Company recorded significant reserve strengthening in losses and LAE. However, the examiners determined that the subsequent strengthening was not adequate. As a result, the examination adjustments posted to the 2003 examination financial statements are higher than the subsequent strengthening recorded by the Company. (See Instruction 1 and examination adjustment A1)

### Litigation

The review of material pending litigation involving Farmers P&C Companies was conducted within two categories of litigation: (1) non-class action non-claim related lawsuits, and (2) class action lawsuits - either claims related or non-claims related. The Company provided listings of litigation outstanding as of December 31, 2003 and discussed the general nature and circumstances of the cases. However, the Company limited examination access to supporting documentation and specific attorney discussion to only what the Company deemed to be in the public domain. The Company declined to provide the examiners additional specific information or documents, citing attorney-client privilege and attorney work-product protection.

Based on limited discussions with the Company's attorneys and the limited review of public domain documents obtained, the examiners drew the conclusion that few, if any, of the category (1) - non-class action non-claim-related lawsuits had a significant probability of resulting in liabilities that would be material to the Farmers P&C companies as a whole. It is anticipated that most of the costs of these lawsuits would be spread among the Farmer's P&C companies based on their respective participation in the reinsurance pool.

Based on discussions with the Company's attorneys and the limited review of public domain documents obtained, the examiners were able to obtain an understanding of the volume and range of category (2) - class action either claims-related or non-claims-related lawsuits for which the Farmers P&C companies appear to be exposed. However, due to limited access to only public domain documents and attorney discussions, a sufficient and complete understanding of the contingent liability exposure for category (2), other than the two specific cases discussed below, was not possible.

As discussed in the Instructions section of this report, the Company was a party to two material lawsuits regarding claims adjusters overtime: (1) Bell vs. FIE (the "Bell" Case), which is a class-action suit specific to California-region employees, and (2) a second case similar to the Bell case, which was filed in Oregon. Subsequent to filing, the second case consolidated other similar cases of non-California regions into a Federal Court in Oregon. Subsequent NAIC Annual Statement disclosures, the apparent facts of the cases, and subsequent settlement activity indicate that these two class-action lawsuits were accruable liabilities at December 31, 2003. (See Instruction 2 and examination adjustment A2)

## FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS

The previous examination included four instructions. A description of the previous instructions and their disposition follows.

1. The Company was instructed to submit all investments owned which have not been rated by the NAIC Securities Valuation Office (SVO) to the SVO to obtain the appropriate rating and reporting value.

   **Disposition: The review of investments for the period under examination concluded that the Company is in compliance.**

2. The Company was instructed to exercise the necessary controls to assure that financial statements reflect accurate information.

   **Disposition: The Company's 2003 NAIC Annual Statement contained inaccurate information. (See Instruction No. 5)**

3. As of the date of the last examination, the Company did not have a tax sharing agreement. It was recommended that the Company execute a separate federal income tax sharing agreement that would allocate the taxes on a stand-alone basis. In addition, the Company was instructed to review the federal tax allocation process such that the participants receive an equitable allocation of taxes on a stand-alone basis.

**Disposition: The Company executed a Tax Sharing Agreement on May 1, 1995. The Agreement allocates taxes on an equitable, stand-alone basis.**

4. The Company was instructed to develop procedures to assure that claim files prepared by various claims offices are maintained on a consistent basis with adequate data and information to determine how the claim was settled.

   **Disposition: As part of the claims review, the examiners pulled a sample of claims to validate the data between the claim file and the accounting system. For two lines of business, there were several files that could not be located by the Company. The examiners then took a second sample for these lines of business. The same problem was found in the second sample as was found in the first and several files could not be located by the Company.**

   Although the Company has not complied with the instruction from the previous examination report, it has made progress toward its resolution. Specifically, it has been rolling-out the Claims Restoration Network (CRN), which is an imaging system that will eliminate paper claim files. Because of the size of the Farmers P&C Companies, this change-over is an enormous endeavor and is being rolled-out state-by-state and by line of business. Currently, some states are submitting 100% of claims through CRN. However, CRN has not been rolled-out to all states or for all lines of business. The Company expects the completion of the CRN roll-out to alleviate the issues with claims files.

## FINANCIAL STATEMENTS

The following examination financial statements show the financial conditions of the Company as of December 31, 2003:

Assets, Liabilities, Surplus and Other Funds
Statement of Income and Capital and Surplus Account
Reconciliation of Surplus for the Period Since the last Examination
Analysis of Changes in Financial Statements Resulting from the Examination

Farmers Insurance Company of Washington
Assets, Liabilities, Surplus and Other Funds
December 31, 2003

| Assets | Balance Per Company | Examination Adjustments | Balance Per Examination | Notes |
|---|---|---|---|---|
| Bonds | $ 263,816,400 | | $ 263,816,400 | |
| Stocks: | | | | |
| Preferred stocks | 4,936,812 | | 4,936,812 | |
| Cash and short-term investments | 2,319,384 | | 2,319,384 | |
| Subtotal, cash and invested assets | $ 271,072,596 | $ 0 | $ 271,072,596 | |
| Investment income due and accrued | 2,579,258 | | 2,579,258 | |
| Agents' balances or uncollected premiums: | | | | |
| Premiums and agents' balances in course of collection | 7,583,559 | | 7,583,559 | |
| Premiums, and agents' balances and installments booked but deferred and not yet due | 22,926,061 | | 22,926,061 | |
| Accrued retrospective premiums | 237,318 | | 237,318 | |
| Reinsurance: | | | | |
| Amounts recoverable from reinsurers | 3,732,514 | | 3,732,514 | |
| Federal and foreign income tax recoverable | - | 7,117,349 | 7,117,349 | A3 |
| Net Deferred Tax Asset | 8,625,057 | | 8,625,057 | |
| Guaranty funds receivable or on deposit | 644,947 | | 644,947 | |
| Receivable from parent, subsidiaries and affiliates | 6,886,104 | | 6,886,104 | |
| Aggregate write-ins for other than invested assets | 25,285 | | 25,285 | |
| **Total Assets** | $ 324,312,699 | $ 7,117,349 | $ 331,430,048 | |
| | | | | |
| **Liabilities** | | | | |
| Losses and loss adjustment expenses | $ 121,654,573 | 17,835,000 | 139,489,573 | A1 |
| Reinsurance payable on paid loss and loss adjustment expenses | 13,199,107 | | 13,199,107 | |
| Taxes, licenses and fees (excluding federal and foreign income taxes) | 367,281 | | 367,281 | |
| Unearned premiums | 74,871,466 | | 74,871,466 | |
| Dividends declared and unpaid: | | | | |
| Policyholders | 80,000 | | 80,000 | |
| Ceded reinsurance premiums payable | 5,589,372 | | 5,589,372 | |
| Aggregate write-ins for liabilities | 1,463,854 | 3,936,000 | 5,399,854 | A2 |
| **Total Liabilities** | $ 217,225,653 | $ 21,771,000 | $ 238,996,653 | |
| | | | | |
| **Surplus and Other Funds** | | | | |
| Common capital stock | 650,000 | | 650,000 | |
| Gross paid in and contributed surplus | 143,223,500 | | 143,223,500 | |
| Unassigned funds | (36,786,454) | (14,653,651) | (51,440,105) | A1, 2, 3 |
| **Surplus as regards policyholders** | $ 107,087,046 | $ (14,653,651) | $ 92,433,395 | |
| **Total Liabilities, Surplus, and Other Funds** | $ 324,312,699 | $ 7,117,349 | $ 331,430,048 | |

Farmers Insurance Company of Washington
Statement of Income and Capital and Surplus Account
For the Year Ended December 31, 2003

| | Balance Per Company | Examination Adjustments | Balance Per Examination | Notes |
|---|---|---|---|---|
| **Underwriting Income** | | | | |
| Premiums earned | $ 168,449,251 | | $ 168,449,251 | |
| **Deductions** | | | | |
| Losses and loss adjustment expenses incurred | 129,275,529 | $17,835,000 | 147,110,529 | A1 |
| Other underwriting expenses incurred | 40,207,723 | | 40,207,723 | |
| Aggregate write-ins for underwriting deductions | (12,309) | | - | |
| Total underwriting deductions | 169,470,943 | 17,835,000 | 187,318,252 | |
| **Net underwriting gain or (loss)** | (1,021,692) | (17,835,000) | (18,869,001) | |
| **Investment Income** | | | | |
| Net investment income earned | 12,597,036 | | 12,597,036 | |
| Net realized capital gains or (losses) | 411,970 | | 411,970 | |
| Net investment gain or (loss) | 13,009,006 | - | 13,009,006 | |
| **Other Income** | | | | |
| Net gain or (loss) from agents' or premium balances charged off | (1,264,401) | | (1,264,401) | |
| Aggregate write-ins for miscellaneous income | (381,340) | (3,936,000) | (4,317,340) | A2 |
| **Total other income** | (1,645,741) | (3,936,000) | (5,581,741) | |
| Dividends to policyholders | 82,921 | | - | |
| Net income, after dividends to policyholders but before federal and foreign income taxes | 10,258,652 | (21,771,000) | (11,512,348) | A1, A2 |
| Federal and foreign income taxes incurred | 3,024,975 | (7,117,349) | (4,092,374) | A3 |
| **Net income** | $ 7,233,677 | $ (14,653,651) | $ (7,419,974) | |
| **Capital and Surplus Account** | | | | |
| Surplus as regards policyholders, December 31 prior year | $98,276,614 | | $98,276,614 | |
| **Gains and (Losses) in Surplus** | | | | |
| Net income | 7,233,677 | $ (14,653,651) | (7,419,974) | |
| Change in net unrealized capital gains or (losses) | 1,135,790 | | 1,135,790 | |
| Change in net deferred income tax | 277,644 | | 277,644 | |
| Change in nonadmitted assets | 134,390 | | 134,390 | |
| Aggregate write-ins for gains and losses in surplus | 28,931 | | 28,931 | |
| Change in surplus as regards policyholders for the year | 8,810,432 | (14,653,651) | (5,843,219) | |
| **Surplus as regards policyholders, December 31 current year** | $ 107,087,046 | $ (14,653,651) | $ 92,433,395 | |

Farmers Insurance Company of Washington
*Reconciliation of Reported Surplus for the Period since the Last Examination
For the Year Ended December 31,

| | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 |
|---|---|---|---|---|---|---|
| **Capital and surplus, December 31, previous** | $ 98,276,614 | $ 93,434,768 | $ 103,363,721 | $ 117,057,387 | $ 120,746,646 | $ 117,592,649 |
| Net income | 7,233,677 | 5,427,972 | (18,649,895) | (12,312,214) | (3,970,968) | 4,356,548 |
| Change in net unrealized capital gains or (losses) | 1,135,790 | (674,225) | 1,267,630 | (1,565,796) | 256,432 | (1,376,662) |
| Change in net deferred income tax | 277,644 | (439,897) | 1,626,317 | - | - | - |
| Change in nonadmitted assets | 134,390 | 663,959 | (1,320,825) | - | - | - |
| Change in excess of statutory reserves over statement | - | - | - | 396,000 | (296,000) | (100,000) |
| Change in surplus notes | - | - | (87,500,000) | - | - | - |
| Surplus adjustments: | | | | | | |
| Paid in | - | - | 87,500,000 | - | - | - |
| Extraordinary amounts of taxes for prior years | | | | (569,290) | 436,273 | 592,093 |
| Cumulative effects of changes in accounting principles | - | - | 7,142,000 | - | - | - |
| Aggregate write-ins for gains and losses in surplus | 28,931 | (135,963) | 5,820 | 357,634 | (114,996) | (317,982) |
| Change in surplus as regards policyholders for the year | 8,810,432 | 4,841,846 | (9,928,953) | (13,693,666) | (3,689,259) | 3,153,997 |
| Surplus as regards policyholders, December 31current | $ 107,087,046 | $ 98,276,614 | $ 93,434,768 | $ 103,363,721 | $ 117,057,387 | $ 120,746,646 |

*Based on Company's filed NAIC Annual Statements

Farmers Insurance Company of Washington
Analysis of Changes in Financial Statements Resulting from the Examination
December 31, 2003

| | PER COMPANY | PER EXAMINATION | EXAMINATION ADJUSTMENT REFERENCE | INCREASE (DECREASE) IN SURPLUS | TOTAL |
|---|---|---|---|---|---|
| **Capital and Surplus, December 31, 2003 Per Annual Statement** | | | | - | **$ 107,087,046** |
| Losses and LAE reserves | $ 121,654,573 | $ 139,489,573 | A1 | $ (17,835,000) | |
| Aggregate Write-ins for Liabilities | 605,700 | 4,541,700 | A2 | (3,936,000) | |
| Income Taxes Incurred | 3,024,975 | -4,092,374 | A3 | 7,117,349 | |
| **Change in surplus** | | | | | **(14,653,651)** |
| **Capital and Surplus, December 31, 2003 Per Examination** | | | | | **$ 92,433,395** |

# NOTES TO THE FINANCIAL STATEMENTS

The Company has no special consents, permitted practices or orders from the state of Washington

## A1. Increase in Loss and LAE Reserves

Because the business of the Farmers Property & Casualty companies is pooled, it was necessary to review the losses on a group-wide basis (the non-pooled business was not reviewed). American Actuarial Consulting Group, LLC, was retained by the CDI to conduct a review and provide an opinion on the loss and loss adjustment expense reserves carried by FIE as of December 31, 2003. A casualty actuary from the CDI reviewed the work of the consulting actuary.

Based on the actuarial review mentioned above, FIE had an indicated combined net loss and loss adjustment expense reserve deficiency of $469,374,000 as of December 31, 2003. The Company's pooled potion of the deficiency is $17,835,000, which has been posted as examination adjustment No. A1.

## A2. Contingent Litigation

The Company was a party to two material lawsuits regarding claims adjusters overtime: (1) Bell vs. Farmers Insurance Exchange (the "Bell" Case), which is a class-action suit specific to California-region employees, and (2) a second case similar to the Bell case, which was filed in Oregon. Subsequent to filing, the second case consolidated other similar cases of non-California regions into a Federal Court in Oregon. Subsequent NAIC Annual Statement disclosures, the apparent facts of the cases, and subsequent settlement activity indicate that these two class-action lawsuits were accruable liabilities as of December 31, 2003.

In their 2004 NAIC Annual Statements, the Farmers P&C companies accrued total expenditures for the combined expected resolution of these two cases in a group-wide amount of $224.8 million. This accrual was for activity prior to 2004 and anticipated overtime compensation and interest for calendar year 2004. The total amount for these two cases that would be relevant to a December 31, 2003 accrual was $227,100,654. Company personnel provided the examiners with a further breakdown of this amount, less a $30.3 million liability already carried group-wide for the Bell case. This amount was allocated by company based on its respective participation in the reinsurance pool. The additional group-wide accrual indicated was $196,800,654. FICOWA's portion of this additional liability was $3,936,000. An adjustment in the amount of $3,936,000 is included in the financial statements of this examination report as adjustment No. A2. This adjustment is classified as aggregate write-ins for liabilities in the Company's NAIC Annual Statement and in this examination report.

## A3. Income Tax Effect of Adjustments

An adjustment was posted to reflect the $7.1 million tax benefit resulting from adjustments A1 and A2. The loss reserve adjustment was discounted by 8% before applying the statutory income tax rate of 35%. This was necessary to reflect the estimated discount required in the calculation of taxable income by the Internal Revenue Service. A 35% statutory tax rate was applied to the contingent litigation adjustment.

The Company incurred income taxes of $7.7 million, $3.1 million and $1.8 million in 2004, 2003 and 2002, respectively. The $7.7 million incurred in 2004 included a reduction of $3.4 million for the tax benefit related to the $10.6 million of reserve strengthening for years 2003 and prior included in 2004 income. Based on the foregoing, it was concluded that the Company could reasonably expect to recover the $7.1 million income tax recoverable, and it was admitted in the adjusted financial statements in accordance with SSAP No. 10.

## ACKNOWLEDGMENT

Acknowledgment is hereby made of the cooperation extended to the examiners by the staff of Farmers Insurance Company of Washington and the California examiners during the course of this examination.

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner; Jerry Epler; CPA/ABV, AFE, John J. Gaynard, CPA, CFE, CPCU, Reinsurance Specialist; Jeanette J. Liao; Adrienne C. DeBella; Youngjae Lee, Insurance Examiners; Timothy F. Hays, CPA, JD, Investment Specialist; and John R. Jacobson, AFE, Automated Examination Specialist, all from the OIC, participated in the examination and the preparation of this report.

Respectfully submitted,

Timoteo L. Navaja, CFE, CIE
Examiner in Charge
State of Washington

<u>**AFFIDAVIT**</u>

**STATE OF WASHINGTON** }
} ss
**COUNTY OF KING** }

Timoteo L. Navaja, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of Farmers Insurance Company of Washington was performed in a manner consistent with the standards and procedures required or prescribed by the OIC and the National Association of Insurance Commissioners (NAIC).

Timoteo L. Navaja, CFE, CIE
Examiner-in-Charge
State of Washington

Subscribed and sworn to before me this 23rd day of June, 2005.

Notary Public in and for the
State of Washington.

COLLEEN JANSEN
COMMISSION EXPIRES
NOTARY
PUBLIC
5-17-08
STATE OF WASHINGTON